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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

Nos. 11-19, 32

IN THE MATTER
OF
CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY,
Debtor.

GROUP OF INSTITUTIONAL INVESTORS and MUTUAL SAVINGS BANK GROUP,
Petitioners,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, *et al.*,
Respondents.

RECONSTRUCTION FINANCE CORPORATION,
Petitioner,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, *et al.*,
Respondents.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit

BRIEF ON BEHALF OF CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, DEBTOR, RESPONDENT

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October 5, 1942.

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BRIEF ON BEHALF OF CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, DEBTOR, RESPONDENT

Opinions Below

The reports and orders of the Interstate Commerce Commission, dated February 12, 1940 and June 4, 1940, are reported at 239 I. C. C. 485 and 240 I. C. C. 257 (Original Report, R. 2153-2269; Original Order, R. 1258-1283; Supplemental Report, R. 1284-1317; Supplemental Order, R. 1319-1347).

The opinion of the District Court dated October 21, 1940, is reported at 36 Fed. Supp. 193 (R. 1857-1899). Its findings of fact, conclusions of law, order and decree were entered on November 13, 1940 (R. 1978-1992).

The opinion of the Circuit Court of Appeals is reported at 124 Fed. 2nd 754 (R. 2297-2317, R. 2334-2335).

Jurisdiction

The decision of the Circuit Court of Appeals was dated December 4, 1941 and was modified on January 12, 1942. The petitions for certiorari were filed on January 17, 1942 and were granted on June 8, 1942. Petitions for certiorari filed by certain Respondents are still pending in this Court.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925 (28 U. S. C. A. Section 347(a)) and Section 24(c) of the Bankruptcy Act as amended (11 U. S. C. A. § 47(c)).

Statute Involved

The statute involved is Section 77 of the Bankruptcy Act (11 U. S. C. A. Section 205). The pertinent provisions are set forth in the course of the argument hereinafter.

Questions Presented

1. Whether the Commission's reports in this case and the opinion of the District Judge adequately stated the reasons for the conclusions contained therein, as required by the Act,

2. Whether the reasons for the conclusions of the Commission and of the District Judge in proceedings under Section 77 must be fully stated in their opinions in order to satisfy the requirements of due process of law.

3. Whether the District Judge must take account of evidence and events which occur after the report of the Commission has been certified to him and which bear upon the propriety of the Plan before he reaches his conclusions.

4. Whether the distribution of new securities in a plan of reorganization can properly be made without an adjudication of conflicting claims to liens on substantial portions of the debtor's property.

5. Whether such distribution of securities can properly be made without an adequate and reliable formula for the segregation and allocation of earnings and expenses among the several divisions of the Debtor's property which are subject to different liens or leases.

6. How the valuation provision in subsection (e) of the Act should be interpreted and what is the meaning of the phrase "earning power."

7. What is the duty of the Commission, when a Plan is referred back to it, with regard to the consideration of evidence of events since its original hearings.

Importance of This Case

This case, and the case of The Western Pacific Railroad Company, are the first to reach this Court involving the general meaning and scope of Section 77 of the Bankruptcy Act. Petitions have already been filed with this Court by

certain other railroads for review of reorganization proceedings. Plans of reorganization for over thirty others are pending before the Circuit Court of Appeals or the District Courts or the Interstate Commerce Commission. (Annual Report of Interstate Commerce Commission for 1941, p. 68 and Appendix G.)

In almost all of these cases certain common problems have been raised, and disagreement and confusion have arisen in the interpretation of the statute. Delay and expense have resulted, to the detriment of the railroads, their credit, the holders of their securities, and the public. Determination by this Court of the meaning of the statute and the duties of the Commission and the courts is of the utmost importance.

Five of the other Class I railroads which are now in reorganization under Section 77 have joined in asking counsel for the Debtor to file a brief as *amicus curiae* on their behalf in this proceeding. That brief is herein referred to as the Brief for the Five Railroads. The Debtor concurs in all that is said therein.

Statement

The brief dated September 21, 1942, filed by the Group of Institutional Investors and Mutual Savings Bank Group (hereinafter referred to as the Group) contains a "Statement of the Case" which the Debtor is willing to accept as a statement of the facts therein set forth. We cannot agree with its conclusions, opinions or characterizations,*

* As for instance the statement that the capitalization of the new company was based upon "an exhaustive study" of all of the elements of value (p. 11), or that the Commission stated the reasons for its conclusions (p. 1.), or that the District Court exercised "an independent judgment" (p. 17), or reached its own conclusion on every essential feature of the plan (p. 18).

however, nor the statement that the Commission determined "the respective lien positions of the several mortgages, the relative earning value of each line" (p. 13). Moreover, it is inadequate in some respects in that it does not state all of the facts which we believe this Court will need to consider in order to determine the propriety of the action of the Commission and the lower courts. In the interest of brevity we will describe such additional facts in connection with the arguments hereinafter based upon them, and will limit this Statement to a brief summary of the origin and course of the proceedings before the Commission.

The history of the inception of these proceedings is described in the Report of the Commission at pages 2177 and 2178 of the record. During the early part of the depression shortage of cash forced the Debtor to borrow from the Reconstruction Finance Corporation. Accrual of unpaid interest became a matter of serious concern to the management. No bonds could be drawn down under the first and refunding mortgage to reimburse the treasury for capital expenditures until deficiencies in equipment replacements under the covenants of the mortgages executed in connection with the 1928 reorganization had been made good. "Under these circumstances there was no available means of financing, even if a substantial restoration of earning power should occur." A surplus of equipment developed with the drop in traffic, but as worn-out cars were retired the equipment deficiencies under the covenants of the mortgages increased, and these were not satisfied by the purchase of new equipment under equipment trusts (R. 2177-8).

Consideration was given to the revision of the mortgages and capital structure. A special committee of di-

rectors was appointed to submit recommendations, and conferences were held with the Reconstruction Finance Corporation and a further loan obtained. In March, 1935, the directors ordered the officers to prepare a plan to meet the situation. This was done in collaboration with representatives of certain large insurance companies, banks and other institutions. The plan so agreed upon was filed at the same time as the petition for reorganization under Section 77 (R. 2178).

Thus it will be seen that shortage of cash caused initially by the depression, but accentuated by the provisions of the outstanding mortgage indentures, was the precipitating cause of this reorganization. The Debtor was not insolvent. It was merely "unable to meet its debts as they mature" (See subsection 77(a)) because restrictive mortgage covenants limited the amount of cash it could raise.

The plan so agreed on was in effect a "stand-by arrangement for a period of economic readjustment" (R. 537). Hearings were held before the Commission in August, 1935, and evidence was presented in support of this plan. Inasmuch as no readjustment of liens was contemplated there were no segregation or severance or other such studies prepared to show accurately the earnings or values of the several divisions of the Debtor's system which are subject to separate liens or leases. Nor was it considered necessary to determine which mortgage had priority of lien rights in certain portions of the property.

After three days the hearings were adjourned to permit the preparation of certain information requested by the Commission's Bureau of Finance for the purpose of bringing up to date the record on the Debtor's operations and financial condition (R. 548-9).

This information was presented at hearings in June, 1937. The Debtor immediately asked for a six months' postponement on the ground that a fair plan could not be prepared under the conditions then existing (R. 620-3). The Group agreed to this request (R. 629-30). The motion was denied and the hearing was continued to September 20, 1937 (R. 633).

On September 20, 1937 the Debtor again requested postponement and the request was again denied (R. 687-90). Hearings lasted one day, and in spite of the objections of the Debtor and many of the creditor parties the record was closed at the end of that day (R. 691).

Four days later the Group asked the Commission for permission to file a new plan and for reopening of the record to receive evidence in support of it. This request was granted on condition that the plan be filed not later than January 10, 1938, and hearings were set for February 1, 1938 (R. 692). On January 10, 1938, the Group filed a plan (R. 695) which became the basis of the plan later approved by the Commission.

Hearings on the Group's plan were held in February and March, 1938, and in spite of requests by the Debtor and several other parties for further hearings the record was finally closed on March 22, 1938 (R. 1021, 1155-8, 2207). Subsequent petitions by committees for the common and preferred stockholders of the Debtor for permission to present a new plan and evidence thereon were also denied (R. 1249-54).

Summary of Argument

I. Both the Commission and the District Court failed to comply with the requirements of the statute in that they did not state the reasons for their conclusions.

II. Both the Commission and the District Court failed to interpret correctly the provisions of Section 77(e) relating to the determination of values.

III. The Plan must be disapproved because it is based on a determination of total capitalization and a finding of no equity for the stock which were erroneous as shown not only by the record before the Commission but even more strikingly by subsequent events.

IV. The Plan must be disapproved because the Record was inadequate to permit either the Commission or the District Court to determine whether the treatment approved for the several classes of creditors and stockholders was fair and equitable and afforded due recognition to their respective rights.

ARGUMENT

I. Both the Commission and the District Court failed to comply with the requirements of the statute in that they did not state the reasons for their conclusions.

The Circuit Court of Appeals has ordered this case sent back to the Commission because of failure to make certain "findings." In so doing we respectfully suggest that the Appellate Court was right as far as it went, but that it did not go far enough. It obviously perceived that there was something fundamentally wrong with the action of the Commission and the approval thereof by the District Court, but we submit that it did not make clear what the error was and that its opinion did not reach to the heart of the difficulty.

The real error committed by the Commission and the District Court lies deeper than the mere lack of "findings." The lack of a statement of the reasons for the conclusions reached by those tribunals vitiates their actions.

Section 77 requires that both the Interstate Commerce Commission and the District Court shall be satisfied that the plan complies with all of the requirements enumerated in subsections (b) and (e). For present purposes these requirements may perhaps be sufficiently summarized by saying that the plan "must be fair and equitable" and must "afford due recognition to the rights of each class of creditors and stockholders" (subsection (e)).

The Commission cannot approve a plan which does not "in its opinion" comply with these requirements (subsection (d)). The District Court cannot approve unless "satisfied" that it complies with them (subsection (e)).

In stating its approval each tribunal must file a written opinion in which it must set forth the reasons for its conclusions. The Commission must render a report in which it "shall state fully the reasons for its conclusions" (subsection (d)). The judge "shall file an opinion, stating his conclusions and the reasons therefor" (subsection (e)). Neither tribunal can fulfill its responsibility merely by describing the evidence and stating its findings or conclusions. Each must also explain the reasoning by which it arrived at those conclusions, why it found as it did find.

In this respect Section 77 differs from other statutes governing the relation between courts and administrative tribunals. When a court is exercising no more than its inescapable power of judicial review of the order of an administrative body, its duties are confined within a narrow compass and it is a simple matter for the administrative body to satisfy the court. As this Court has recently said:

> "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end." *Power Commission v. Pipeline Co.*, 315 U. S. 575 at 586.

"Proper findings" require an adequate basis of evidence, but if there is sufficient evidence from which the

findings could reasonably have been made, it is no concern of the courts how they were reached.

This assumes, of course, that a "fair hearing" has been given. And a fair hearing requires that all the evidence be disclosed. In *Ohio Bell Telephone Company* v. *Commission*, 301 U. S. 292, this Court said:

> "The fundamentals of a trial were denied to the appellant when rates previously collected were ordered to be refunded upon the strength of evidential facts not spread upon the record" (p. 300).

But in proceedings under Section 77 the function and duty of the court go beyond simple judicial review of the Commission's plan of reorganization. One of the express consequences of their "intertwined" functions is the requirement that each should give to the other the "reasons" for its conclusions and opinions. The judge in order to be satisfied that the plan complies with the statute must determine whether in his official capacity, charged with responsibility for all of the matters which enter into the determination of bankruptcy and reorganization cases, he agrees with the conclusion reached by the Commission. It is not enough for him merely to convince himself that the Commission had some evidence before it on which that conclusion could be based. The judge must therefore be informed not only of the evidence which the Commission considered, but of the reasons why it proceeded from such evidence to that particular conclusion. The judge is not expected to start over from the beginning and work out a conclusion of his own because his duty is limited to approving or disapproving the plan certified by the Commission, but he cannot independently satisfy himself of the fairness of that plan without knowing why the Commission approved it rather than some other plan.

Another and equally important reason why Congress required both the Commission and the court to state the reasons for their conclusions is that when a plan is submitted to creditors and stockholders it must be accompanied by both "the report or reports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge" (subsection (e)). In order that creditors and stockholders may have adequate protection in the determination of their rights when they are called upon to vote on the plan and in making their objections to the Court and to the Commission, they must be given full information as to the reasons for changes, curtailments or eliminations of such rights. They are entitled by the statute to have the plan afford "due recognition" to their rights, to be non-discriminatory and to conform to the requirements of the law of the land regarding their participation in the reorganization (subsection (e)). In order that they may know whether the plan, when submitted to them, does comply with these requirements, they must be told why the Commission and the court approved the proposed treatment for those rights. The creditors and stockholders do not have the advantage of seeing and hearing witnesses, or studying exhibits. They are forced to decide whether to accept or reject the plan on the basis of the plan itself and what is disclosed in the opinions of the Commission and the court.

The requirement that the District Judge as well as the Commission state the reasons for his conclusions is also essential to the working of the cooperative machinery set up in Section 77. It is necessary not only for the protection of creditors and stockholders, but also in order that the Circuit Court of Appeals may be able fully to test the correctness of his decision and that the Commission, if the

plan is disapproved and sent back to it may have the benefit of his reasons in preparing a new plan.

Turning to the Commission's discussion of valuation in this case, we find no more than a catalogue of values, the original cost, the valuation under Section 19a, the reproduction cost depreciated, the investment, the capitalization (R. 2164). There is no discussion of their respective relevance or of the weight which the Commission gave to any of them. Therefore, of course, there is no statement of the reasons for such relevance or weight. The Commission seems to have followed Commissioner Prouty's advice, "Go ahead and make your values, but do not tell anybody how you do it." *

If we look for a discussion of the prospective earning power, we are equally disappointed. A report on the Debtor's freight traffic and earnings from 1921 to 1935 had been prepared by the Bureau of Finance, and a summary showing freight tonnage by commodities divided into five categories and distributed over five periods. This is quoted and briefly summarized in the Commission's report followed by a tabulation of freight and total revenues from 1927 through 1937 and a statement concerning passenger and all other revenues in the same period (R. 2176-7).

There is, however, no analysis of the future of the traffic in the light of developments in the territory or probable trends. Nothing is said concerning probable or possible

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* "The wisest thing that was ever said to the Interstate Commerce Commission—and I have no doubt that men are within the sound of my voice who heard it said—was said by Commissioner Prouty one day 15 or 20 years ago. We were talking to the Commission—it was after he left the Commission; he was in charge of the Bureau of Valuations; and I hope these gentlemen will correct me if I am wrong—he stood up and said to the Commission:

"'Go ahead and make your values but do not tell anybody how you do it, because if you lay down a rule, somebody is going to attack the rule. If you make your values let them attack the values, but keep your rule to yourself.'" (Hearings before Committee on the Judiciary, House of Representatives, 74th Congress, 1st Session, on H. R. 6429, p. 278.)

changes in plant, methods or efficiency such as might affect the operating ratio and the amount of gross that would be available for fixed charges.

This falls far short of an adequate study of prospective earning power. It gives no clue to why these past facts were to be taken as indicative of the future. Did the Commission really believe that depression conditions would last indefinitely in the Debtor's territory? If so, it should have explained the reasons for such lack of optimism. If not, it should have made some attempt to forecast the effect of the improvement it considered likely.

The Group assert that they can find four "reasons," within the meaning of the statute, which the Commission stated for its conclusion that the stock had no value. These are listed on pages 56 and 57 of the Group's Brief. We submit that they prove the point we are making.

The first is the fact that no dividends have been paid on the stock since 1917. The second is the record of earnings for the period 1910-1938. The third is the income available for interest in selected shorter periods within the depression portion of this era, 1930-1936, 1937, 1938, 1930-1938. All these, it will be noted, are the *past* earnings which we have discussed, all prior to the end of 1938. Also, in the third, is the estimate of the Group Committee; not the Commission, of what it calls "future normal earnings," and the conclusion of the Commission that it is "evident" that the stock has no value. The fourth "reason" is merely the Commission's summarization of the provision of subsection (e) requiring it to make "findings" in connection with the submission of a plan to the stockholders and a reference to *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106.

If our position is sound, none of these is the kind of reason that Congress required of the Commission, and if the Group is right, as it is, that these are the only "reasons" to be found in the report, then the Commission failed to perform its duty under the Act.

The kind of reasons which are required in evaluating future earning power is exemplified in two cases arising under Section 77 relating to the value of a long term lease, which, like the question we have here, requires an estimate of future values. In *Palmer* v. *Connecticut R. & L. Co.*, 311 U. S. 544 at 554, this Court said:

> "The court pointed out that no evidence of transportation experts or surveys was offered to assist it in appraising possibilities of the development of the territory, of increased operating efficiency or the effects of consolidation."

And in a footnote,

> "See another New Haven long term lease, *In Re New York, N. H. & H. R. Co.*, 30 F. Supp. 541, where evidence of this kind appears."

An examination of the District Court's opinion in the latter case will show the kind of reasons which Congress expected of the Commission, and likewise of the Court. The judge examined the character of the territory through which the leased line ran and its principal industries. He was provided with a study of the trends in each, projecting past facts and developments into the future on the basis of the opinions of those familiar with them. He discussed the cities and towns through which the road ran and the ratio of their products to the total for the rest of the country, their probable rate of growth and decline. These economic trends he found to be directly reflected in the traffic over the road. He found that the passenger traffic was

local and moved at unremunerative commutation rates and he had expert opinion as to its probalities and possibilities. He considered the competition by trucks and automobiles, and had before him maps of traffic flow in different years and evidence of developments which would be likely to affect such competition in the future. He discussed statistics of water-borne traffic and of airplane traffic and their possibilities for the territory. He had studies and he expressed opinions on possible economies, facilities which might not be needed, the suitability and adequacy of the equipment in use and the possibility of substituting more modern types (30 Fed. Supp. at pp. 544-9). In short, he looked as far as he could into the future and considered not only the past but economic trends and traffic potentialities of the territories he was studying. His reasoned conclusion is, as he said, only an "incomplete summary of the record," but it contains enough to make a vivid contrast with the report of the Commission in this case.

Neither in determining prospective earning power nor in fixing total capitalization nor in finding that the equity had no value did the Commission perform the duty required of it by Section 77 to give reasons for its conclusions. Thereby it committed error, for its failure made it impossible for the courts to perform their proper function under the statute. The result of these errors is that if the present plan were to be finally consummated, the stockholders and many of the creditors would be deprived of their rights without having had the opportunity to defend them which is guaranteed in the Fifth Amendment.

Due process of law is as much required in the exercise of the bankruptcy power as elsewhere. *Kuehner* v. *Irving Trust Co.*, 299 U. S. 445, 451; *Louisville Joint Stock Land Bank* v. *Radford*, 295 U. S. 555, 589. Obviously, it applies to the exercise of that power by the courts, and under Sec-

tion 77 by the Commission, as well as by Congress. In *Ohio Bell Telephone Co.* v. *Commission, supra,* the lack of evidential facts gave the court no basis to review the decision of the Ohio Commission. The "rudiments of fair play" require that here the reasons, as there the evidence, should be stated, and the failure to state them is just as fatal here as was the failure there to disclose the evidence.

This Court in *Power Commission* v. *Pipeline Co., supra*; said that an administrative agency is not bound to any formula or combination of formulas. The Commission is free "to make the pragmatic adjustments which may be called for by particular circumstances." In Section 77, the valuation provision in subsection (e) is itself a carefully considered injunction to the Commission that it should consider *all* the relevant facts. It does not restrict the Commission to any particular formula. Indeed, its effect is to enjoin the Commission against any particular formula. Therefore, Congress required it to express its reasons. For Congress knew that, in the absence of a formula, that was the only way by which the action of the Commission could adequately be made known or knowable to the parties whose property was at stake. Since due process of law does not require the Commission to act under a formula, Congress was requiring no more than due process in providing that the Commission must state its reasons.

II. Both the Commission and the District Court failed to interpret correctly the provision of Section 77(e) relating to the determination of values.

While the Commission's failure to state its reasons prevents our knowing just why it reached its conclusions as to value and what weight it gave to the various factors which should have been considered in reaching them, there

is enough in its report to indicate some of the things which it did not do. Certainly it failed to understand what Congress meant by the words "earning power" and the part which Congress intended earning power to play in fixing values. Also it clearly indicated a belief that Section 77 constituted a mandate to determine value on a basis which would reduce capitalization as well as fixed charges.

The Commission found the following facts concerning the value of the property of the Debtor (including the Terre Haute):

Total capitalization as of December 31, 1938 (taking no par common stock at $100 per share), $744,760,713 (R. 2174). Total debt as of December 31, 1938 (including unpaid bond interest*), $626,926,331 (R. 2174). Cost of reproduction less depreciation as of December 31, 1937, $662,759,838 (R. 2164). Original cost, including land, $797,932,041 (R. 2164). "The final rate-making value of the combined common-carrier properties, as found by Division 1" and adjusted to reflect additions and betterments down to December 31, 1937, $735,703,231 (R. 2164). Investment in road and equipment as of December 31, 1937 (including the Terre Haute as of April 30, 1937), less accrued depreciation, $669,657,842 (R. 2258-9). Excess of total current assets, deferred assets and unadjusted credits over similar liability items, $13,975,279 (R. 2259). Investment in securities of affiliated companies as of April 30, 1937, par value $24,107,521, book value $12,053,593 (R. 2164). Income available for payment of interest declined from $30,671,632 in 1928 and $29,105,102 in 1929 to a deficit of $232,590 in 1932 and rose to $8,687,380 in 1937.† Since

* See Part IV *infra* as to lack of judicial authority for including $79,550,055 unpaid interest on the Adjustment Mortgage Bonds.

† 1937 was the last year shown at the hearings. The figure for 1938, $4,962,923, was supplied after the close of the hearings and is shown in the Commission's report.

the close of the record before the Commission income available for payment of interest has risen to $28,939,719 in 1941 and is continuing to rise in 1942. (See reports of Debtor's Trustees to the District Court discussed hereinafter in Part III.)

The Commission made no findings as to the "earning power" of the property except the negative one that "there is no evidence whatever to indicate that a recovery of the earning power of 1928-9 is reasonably probable" (R. 2260). It limited total capitalization to $548,533,321, taking the new no par common stock at $100 a share (R. 2218, 2220-1).

The question is which of these various facts are relevant in determining the value of the Debtor's property for purposes of capitalization.

The last paragraph of subsection 77(e) reads as follows:

> "If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan. The value of any property used in railroad operation shall be determined on a basis which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts."

Congress clearly contemplated that determination of value may be necessary for various different purposes. "Value is a word of many meanings," as Mr. Justice BRANDEIS said in his dissenting opinion in *Southwestern Bell*

Telephone Company v. Commission, 262 U. S. 276,
The purpose for which it is used determines the sor
value which is in issue. The weight to be given to v
ous elements in determining value depends upon the
of value involved.

We are here considering value for the purpose of
termining total permissible capitalization for the r
ganized company, the value of its capitalizable assets.
liquidation and distribution of cash or physical assets
impossible in a railroad reorganization, the problem i
determine the rights of the va ious parties to particip
and the extent of their participation, in the estate of
Debtor considered as a going concern. The total valu
the estate is not changed by the reorganization. The ph
cal property remains the same and its operation, earni
and earning power are not affected. All that is chan
are the relative rights of those who claim an interest in
estate.

Because this is the sort of value with which we are
cerned, the facts which are relevant in its determina
and which must be tested by the earning power of the pr
erty, necessarily include the investment in the prope
comprising this going concern and the capitalization
resenting that investment. The railroad has been crea
with capacity to produce certain earnings. Some parts
it are more profitable than others. Occasionally some p
becomes so useless or unprofitable that its abandonmen
permitted. Unless abandonment is permitted it must
be operated and maintained because of the requiremen
public interest, even though some of it may show little
no profit in normal times.

Railroads must maintain their plants not only for
traffi which they ordinarily enjoy, but also to meet em

gencies of all sorts. War is of course such an emergency, but there are others, such as floods, hurricanes, blizzards or casualties of other sorts. The railroads are the backbone of the national transportation system and must be ready to help out all other transportation agencies whenever they need help.

We are therefore concerned with the value of all of the railroad property which the Debtor is required in the public interest to maintain and operate. Only if such property has become permanently obsolete and is no longer required in the public interest, can it be excluded from determination of this sort of value; only, in other words, if it has permanently lost its "earning power."

The last paragraph of subsection (e) twice uses the phrase "earning power," and twice the phrase "all other relevant facts." Congress evidently thought it desirable to emphasize its intention that all elements relevant to value should be taken into consideration, but that the values derived from them should be tested "in the light of" earning power and with "due consideration" for it.

As we have said, in determining value for the purpose of deciding what classes of creditors and stockholders are entitled to participate in a reorganization one of the "relevant facts" is the existing capitalization. That is what we start with because it is largely the rights of those whose securities make up that capitalization that are to be readjusted. The burden of proving that it should be reduced is on him who proposes reduction. Under subsection (e) it must be tested by earning power. Unless in the light of that test existing capitalization is found not to be justified, it cannot be reduced without doing violence to the rights of those excluded by the reduction.

Section 77 was enacted "for the relief of debtors" (U. S. C. A. Section 201). In the words of this Court it was directed at "the rehabilitation of the debtor." *C. R. & L. v. Palmer*, 305 U. S. 493, 501.

While part of the Bankruptcy Act, it is also an important feature of Congress' statutory plan for the maintenance and safeguarding of an adequate national transportation system, and is intended to facilitate the rehabilitation of financially distressed railroads in order that their service to the public may be uninterrupted, constantly improved, and always capable of meeting emergencies.

Its only specific requirement for any change in financial structure is that fixed charges shall be limited to such an amount that "there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof" (subsection (b)(4)). There is no similar requirement with regard to contingent charges or dividends, and no mandate that total capitalization shall be reduced. The legislative history of the Act does not indicate that Congress had any intention to require such reduction. On the contrary, it shows great solicitude lest the credit of the carriers be impaired by unwarranted elimination of the rights of junior claimants. (See Brief for the Five Railroads, Part III.)

The phrase "earning power" is to be distinguished from the word "earnings." As we have just seen, in the provision for coverage of fixed charges it is "the probable prospective earnings" of the property which must be used as the test of future fixed charges. In subsection (e), however, it is the "earning power of the property, past, present, and prospective" that must be used to test the other relevant facts. It cannot be assumed that Congress in using these two different phrases meant the same thing.

If there were any doubt about this, it would be set at rest by the legislative history of the last paragraph of subsection (e). Originally that paragraph required consideration of both "earnings" and "earning power." The word "earnings" was removed by the House Judiciary Committee, however, and does not occur in the section as finally enacted. (See Brief for the Five Railroads, Part IV, A.)

"Earning power" means "earning capacity." This also is indicated in the legislative history of the section (*ideat*). The question is not what the road *will* earn, but what it *can* earn.

The use of earning power rather than earnings as the test of value avoids the vicious circle referred to in the dissenting opinion of Justices BRANDEIS and HOLMES in the *Southwestern Bell Telephone Co. v. Commission*, 262 U. S. 274 at 292, and in the concurring opinion of Justices BLACK, DOUGLAS and MURPHY in *Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575 at 603. As earnings depend largely upon rates and rates are regulated on the basis of values, earnings cannot be used to fix values.

The earning power of a railroad is its capacity to produce net earnings. It is the product of physical capacity to handle traffic, ability to obtain traffic and ability to convert into net earnings the revenues received therefrom. It does not depend upon the rates currently in effect, though the earnings actually produced at any given time are affected by the rate level. The temporary existence or absence of competitive forms of transportation does not necessarily affect earning power, though it may affect earnings for the time being.

Actual earnings, past, present or prospective, are evidence of earning power, but only when considered in the

light of circumstances showing their relation to potential earnings.*

Earning power may be greater than but cannot be less than actual current earnings at any given time, nor can it be held to be less than the highest actual past earnings without proof that conditions under which such earnings were made have permanently changed so as to put their recurrence out of the question.

That the debtor's earning power is sufficient to justify its existing capitalization is amply proven in the available results of its operations in 1941 and 1942. The figures are described hereinafter in Part III. We do not suggest that they furnish an exact measure of earning power, because 1942 is exceeding 1941, and 1943 may well produce still higher results. It is unnecessary, however, to consider how much actual earning power may exceed the current level of earnings because the latter is sufficient to demonstrate that existing capitalization should not be reduced under the provisions of subsection 77(e).

The Debtor's net income available for fixed charges in 1941 was $28,939,719. In the first half of 1942 the figure was $2,363,000 greater than in the first half of 1941. (See Part III, *infra*.) The Commission found that the annual interest charges on the principal of the present debt totalled $23,739,000 (R. 2174), but that if interest on unpaid interest were included they would come to more than $29,000,000 (R. 2259). As we show in Part IV, C, *infra*, the $29,000,000 figure is erroneous because the Adjustment Mortgage Indenture provides that interest shall not be payable on unpaid interest of the Adjustment Mortgage

* For an illustration of the sort of evidence necessary to show such relation see the discussion of the evidence in *Palmer* v. *C. R. & L. Co.*, 311 U. S. 544, and *In Re New York, N. H. & H. R. Co.*, 30 Fed. Supp. 541, in Part I, *supra*.

bonds. The figure should therefore be reduced to $25,726,000. Thus the interest on existing capitalization, even if interest legally payable on unpaid interest is included, would fall more than $3,000,000 short of using up the net available for fixed charges in 1941. And the excess will be very much greater in 1942.

It will doubtless be argued that this statement makes no allowance for federal taxes on current earnings. Our answer is that even if such taxes should turn out to be great enough to leave nothing for the stockholders, the actual earning power, as we have said, may well be considerably greater than the current earnings. Moreover, taxes do not permanently reduce earning power even though for the time being they may take away much of the slack above interest requirements.

It will doubtless also be contended that current earnings are abnormal and cannot last. Even if we were ready to agree to this contention, it would have no bearing on earning power, because that power is actually being demonstrated at the present time. We are not willing, however, to agree that the earnings of the railroads will suddenly or permanently fall off when the war is over. We show in Part III, *infra*, the tremendous expenditures which have been made in improving the Debtor's property and the tremendous increase in the ratio of net earnings to gross revenues which resulted from those improvements and from the increases in efficiency which the Debtor has accomplished during and as a result of the eras of unregulated competition in the 20's and economic depression in the 30's. These, we believe, represent permanent increases in earning power regardless of the level of traffic at any given time. Moreover, we do not admit that current traffic levels are due solely to the war and will be sharply re-

duced when the war is over. Doubtless the country will continue for a long time in the future to experience alternating periods of greater and less prosperity, but the increase in population has not ceased, nor do we believe that the national standard of living has reached its peak. When the exigencies of the war are over, we anticipate resumption of the upward trend and with it increasing demand for transportation of all sorts. While competitive forms of transportation are here to stay, they have become increasingly subject to regulation, and the Transportation Act of 1940 shows Congress' purpose that the railroads, as well as all other forms of transportation, shall be maintained and fostered in the public interest.

We therefore assert that the earning power of the Debtor is sufficient to justify its present capitalization, that existing capitalization cannot be reduced in any plan of reorganization which is fair and equitable and gives due recognition to the rights of existing creditors and stockholders, and that the Commission and the District Court misinterpreted the requirements of the Act in requiring and approving such a reduction.

III. The Plan must be disapproved because it is based on a determination of total capitalization and a finding of no equity for the stock which were erroneous as shown not only by the record before the Commission but even more strikingly by subsequent events.

The plan must be disapproved because the determination of the maximum capitalization, and with it the finding of no equity, whether or not warranted by the evidence before the Commission, are erroneous in the light of subsequent events. A plan based upon such a capitalization and finding cannot

be fair and equitable nor compatible with the public interest, nor can it afford due recognition to the rights of all classes of creditors and stockholders.

On the correct interpretation of Section 77(e), as set forth in Part II, *supra*, the Commission was wrong even on the basis of the record before it. On the basis of earning power the result should have been the same in 1938 as in 1942. But the facts known to the Commission in 1938 did not give it as full and firm a basis for gauging earning power as those now available. Its error is therefore understandable, but nonetheless error. But even if we assume, for the sake of argument, that the Commission's conclusions were correct in 1938, they could not now be approved in the light of what is now known.

Neither the Commission nor the Judge sits as a pie-powder court. A lag between the time when the evidence is presented to them and the time they reach their joint conclusion is unavoidable. But time destroys many things, including, sometimes, the relevance of evidence while decisions are being pondered. When time does this—and time is doing it now more violently than ever before in our history—evidence that has become obsolete may be more than just stale and irrelevant. It may lead us in quite the opposite direction from that in which we should go.

Section 77 requires that the court shall be satisfied that the plan "complies" with its requirements, "is" fair, "affords" due recognition to the rights of all classes, etc. (subsection (e)). These requirements are all expressed in the present tense. It is not sufficient for the judge to be satisfied that the plan "was" fair in the past tense or on the basis of facts known to the Commission at an earlier time. Even if the Commission acted properly in the present tense, its present has become the past by the time the judge acts

and he cannot approve the plan unless he is satisfied that it still "is" fair at the time when he is considering it.*

In Section 77 proceedings the court is sitting in equity, with all the powers

> "which a federal court would have had if it had appointed a receiver in equity of the property of the debtor for any purpose" (subsection (a)).

This was inserted in the Act of 1935, perhaps only to emphasize its importance. This Court had already said in *Continental Bank* v. *Rock Island Railway*, 294 U. S. 648 at 675, that courts of bankruptcy

> "are essentially courts of equity, and their proceedings inherently proceedings in equity * * *."

It is, indeed, essential that when the court sits in proceedings under Section 77 it should sit as a court of equity. Congress did well to emphasize the point. When a court is working with an administrative board, it must be able to

* The procedural provision in subsection (e) that a finding by the Commission that the interest of any class of stockholders or creditors has no value, if affirmed by the judge as of "the time of the finding," makes unnecessary the submission of a plan to such class, relates solely to the right to vote. It does not indicate any intention on the part of Congress that the judge shall determine his satisfaction or lack of satisfaction as of the date of the Commission's decision. If the judge is not satisfied that the plan is fair at the time when he passes upon it, he cannot approve it, and it will therefore not be submitted to any class for acceptance or rejection. Consequently, his approval of a plan which contains a finding of no value for some class necessarily approves that finding as of the date when he acts. In order to eliminate the necessity for submission of the plan to the class in question, however, he must also approve that particular finding as of the date when the Commission made it.

This provision does not necessarily indicate that the class whose interest has thus been found to be of no value will necessarily be excluded from voting or from participation in the reorganization. The statute merely says that if such finding is made and affirmed it "shall not be necessary" to submit the plan to such class. Submission is still permissible. Moreover, participation in the reorganization, even by a class whose interest has been found to be valueless, may be provided for through the issuance of "options or warrants to receive, or to subscribe for, securities of the reorganized company" [subsection (b)(3)]. Such a situation was recognized by this Court in *Case* v. *Los Angeles Lumber Products Company*, *supra*, at p. 121 when it said: "It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor."

adapt its procedure to the administrative purpose. This Court has recently applied this principle to the review of orders by the National Labor Relations Board. In *Ford Motor Co.* v. *Labor Board*, 305 U. S. 364 this Court said on page 373:

> "The jurisdiction to review the orders of the Labor Relations Board is vested in a court with equity powers, and while the court must act within the bounds of the statute and without intruding upon the administrative province, it may adjust its relief to the exigencies of the case in accordance with the equitable principles governing judicial action. The purpose of the judicial review is consonant with that of the administrative proceeding itself,—to secure a just result with a minimum of technical requirements."

There the court exercised only a power to review the orders of the board. Here the principle is even more important, for the court is, so to speak, pulling in double harness with the Commission.

It is the very essence of the administrative process that it acts *in futuro*. All that has happened and that is available up to the last practicable moment must be weighed and considered if the decision is to have any hope of turning out either wise or correct.

Even the rulings of a court reviewing the report and order of a Commission and finding them in error must give way and stand to one side in the light of more recent facts which require the Commission in the performance of its administrative duties to do otherwise than as the court has directed. *Federal Communications Commission* v. *Pottsville Broadcasting Co.*, 309 U. S. 134.* There the company

* And the companion case, *Fly* v. *Heitmeyer*, 309 U. S. 146.

applied for a permit and it was denied by the Commission on a ground which the Court of Appeals of the District of Columbia held erroneous in law. The court remanded the case "for reconsideration in accordance with the views expressed" (139). The Commission set the application down for hearing with two other rival applications which had been filed subsequently, and it was about to consider all three on a comparative basis when the company obtained a writ of mandamus from the Court of Appeals to require the Commission to hear its application on its original basis.

This Court, reviewing the issue of the writ, said that "a much deeper issue" was involved than the familiar doctrine that a lower court is bound to respect the mandate of an appellate tribunal. When the Court of Appeals remanded the case,

> "At this point the Commission was again charged with the duty of judging the application in the light of 'public convenience, interest, or necessity'" (145).

The writ of mandamus was dissolved.

Courts of equity have always rendered their decisions as of the time of the final decree. (See *Randel* v. *Brown*, 2 Howard 406, 423; *United Corporation* v. *Federal Trade Commission*, 110 Fed. (2d) 473; *Stonega Coke and Coal Co.* v. *Price* 106 Fed. (2d) 411, 419.)

On several recent occasions this Court has held it error for a court of equity to confine itself to evidence which had become obsolete and misleading at the time it rendered its decree. (See *Knoxville* v. *Water Company*, 212 U. S. 1; *Atchison, T. S. & S. F. Railway Co.* v. *U. S.*, 284 U. S. 248; *Central Kentucky Co.* v. *Commission*, 290 U. S. 264; *Baltimore & Ohio R. Co.* v. *U. S.*, 298 U. S. 349; *McCart* v. *Indianapolis Water Company*, 302 U. S. 419.) As these cases

are discussed in Part II of the Brief for the Five Railroads we will not analyze them here.

A great deal happened to the Debtor and to the railroad systems of this country, as well as to the rest of the world, between the time the Commission closed its record in March of 1938 and the time it certified its report to the judge on June 4, 1940. Even more happened between then and November of that year when the judge approved the Commission's plan. Changes have been accumulating ever since.

To indicate the inequity of any such course we will consider what each of the three tribunals, the Commission and the two courts, said and did, compare it with the facts before them and the facts that were available to them, and then examine the accumulated error of the result.

The Commission

The Commission fixed total capitalization of the reorganized Debtor at slightly over $548,000,000 and found that the existing stock, preferred as well as common, had no value (R. 2218-20, and 2258-60).

Briefly, what it did was to mention the original cost; the reproduction cost; the rate base; and the investment (R. 2164-5). Then it selected certain past years, all of them within the depression period, and averaged their earnings. It took the five years, 1931-1935, and the seven years, 1930-1936. This was for the purpose of fixing capitalization for the reorganized company. Without further explanation, it fixed on a total capitalization of $108,000,000 of fixed interest debt, $115,000,000 of contingent interest debt, and $108,000,000 of 5% preferred stock; and it added certain shares of no par common stock. "Taking the common stock at $100" (which it was not—it had no par), the Commission fixed on a total capitalization of $548,533,321 (R. 2218-21).

Then the Commission turned to the question of the equity of the old preferred and common stock. What it said on this subject, after again mentioning the figures of total debt, investment in road and equipment, and reproduction cost, is contained in one long paragraph on pages 2259-60 of the Record. That its meaning may be clear, we will quote this paragraph in full, with interpolated comments.

> "The record of the Milwaukee's earnings in the past has been reviewed."

The total revenues and net earnings, no more, were tabulated from 1927 through 1937 (R. 2176).

> "The last year when dividends were paid on the stock was in 1917. Between 1930 and 1936 the income available for payment of interest, as adjusted by the committee and accepted by the debtor, varied between a high level of $20,298,074 and a low of $2,680,530, with an average of $10,270,360. Similarly adjusted, the available income in 1937 was $8,224,809 and in 1938 $6,023,296 bringing the average, 1930 to 1938, to $9,571,180. Future normal earnings were estimated by the committee at $15,894,000 a year."

The figure for 1938 was supplied to the Commission after the hearings closed (R. 2180). We shall come in a moment to what the available income had already become at the time of the Commission's report.

> "When these amounts are compared with the annual interest charges on the principal of the present debt, $23,739,000 a year, it is evident that the earning power of the system *since the period of peak earnings* is entirely inadequate to cover the principal of the debt, disregarding more than $118,000,000* of unpaid

* We discuss in Part IV hereinafter the impropriety of using these figures for unpaid interest and total debt in the absence of judicial determination of the validity of about $80,000,000 included in each representing unpaid contingent interest on the Adjustment Mortgage bonds.

interest. The total debt of $626,926,331 corresponds approximately to an available income of $28,212,000* capitalized at the low rate of 4½ percent." (Italics added.)

The italicized phrase leads up to the reason, and the only reason, why, in the opinion of the Commission, "the earning power of the system * * * is entirely inadequate" to cover the debt.

> "Only in 1928 and 1929 was such earning power demonstrated."

That was then true. It is now demonstrably wrong.

> "We think that the examiner erred in finding a prospective equity for the preferred stock on the basis of $24,459,932 of average available income during the period 1925-29. That amount exceeds the annual charges on the principal of the present debt but does not take into consideration the large accrual of unpaid interest; in addition, it greatly exceeds the amount earned in any year since 1929. Computations were made by counsel for the committee and introduced at the oral argument showing the interest charges on the total debt at more than $29,000,000* a year."

This brings us to the sole "reason" for the Commission's conclusion that there was no equity. It is this.

> "We disagree with the debtor in its contention that the high earning power of the system only 10 years ago indicates the injustice of resolving all uncertainties for the future in such a manner as to forfeit the

* This figure is overstated by $3,738,852, as we show in Part IV, *infra*, due to a failure to notice the provision in the Adjustment Mortgage Indenture that interest shall not be paid on unpaid interest.

> stock. *There is no evidence whatever to indicate that a recovery of the earning power of 1928-29 is reasonably probable, and we regard it as a remote possibility only*, which may not be utilized to support a finding that the debtor's stockholders have an equity. In view of the earnings situation it would be improper to give controlling weight to the fact that the indicated reproduction cost value of the property exceeds the amount of debt. We find that the equity of the holders of the debtor's preferred stock and its common stock has no value and the holders of claims in classes 24 and 25, [preferred and common stockholders (R. 2161)] therefore, are not entitled to participate in the plan" (R. 2259-60).* (Italics added.)

The only statement that could possibly be called a "reason" for the finding of no equity is contained in the italicized words. It is not a reason. It is itself merely a conclusion and is based only on the earnings of certain selected periods, all of them ending in 1938 or earlier, and in no way connected with the future by any analysis of trends or current developments.

Conditions were even then changing. We bring down to date the figures on which the Commission relied. Those in italics are the ones which the Commission did *not* have.

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* In its Supplemental Report of June 4, 1940, the Commission added nothing material on this issue. There it said, after hearing objections,

> "Upon further consideration we are still of the opinion that the equity of the debtor's stockholders has no value and renew our finding to that effect. We are also still of the opinion that, under all pertinent facts and considerations, the probabilities of the property earning sufficient to pay dividends on any securities that could properly be represented by warrants issued under the plan are too remote to justify provision in the plan for such warrants, even though the warrants might provide that the securities be purchased at a stated cash consideration." (R. 1312).

Year	*Gross Revenues*
1936	$109,142,000
1937	107,662,000
1938	*99,436,000*
1939	*106,873,000*
1940	*114,375,000*
1941	*139,646,000*
1941 (first six months)	*$62,107,000*
1942 (first six months)	*$79,560,000*

The figures for 1936 and 1937 are in the Commission's Report (R. 2176). The more recent figures come from the monthly reports of the Trustees to the District Court, which are before this Court by stipulation. Through the first half of 1940, they were in evidence before the District Court. Through most of 1941, they were before the Circuit Court of Appeals by stipulation.

In considering income available for fixed charges, it is illuminating to compare the figures for the years 1928 and 1929, which constituted the supposedly unattainable goal which led the Commission to find no equity, with those for 1941 and 1942.

Year	*Available for Fixed Charges*
1928	$30,671,000
1929	29,105,000
1936	9,706,000
1937	8,687,000
1938	4,962,000
1939	*9,368,000*
1940	*13,993,000*
1941	*28,939,000*
1941 (first six months)	*$11,672,000*
1942 (first six months)	*$14,034,000**

* The 1942 total, based on the ratio of the six months' results, would be $34,900,000.

The figures for 1928 to 1938 are in the Commission's Report (R. 2180). The later ones come from the Trustees' reports to the District Court.

Early in 1940, on the basis of a record already two years closed, the Commission said:

> "There is no evidence whatever to indicate that a recovery of the earning power of 1928-29 is reasonably probable" (R. 2260).

It has been recovered. In 1941, earnings were substantially identical with 1929 and only $1,733,000 under 1928. The first six months of 1942 showed an increase of $2,362,000 over the first half of 1941.

We are not criticizing the Commission when we say that it was wrong. That would be beside the point. We are trying to reorganize a railroad, not as of 1930-36, nor as of 1938, but now, in 1942. And it is plain that if the Commission had had these recent figures it could not have come to the conclusion that "recovery of the earning power of 1928-29" was not "reasonably probable" or was only a "remote possibility." That "earning power" has been recovered, and the fair inference from the sole "reason" which the Commission gave for "forfeit" of the stock is that it would not now reach that conclusion, but would find that such recovery "may * * * be utilized to support a finding that the debtor's stockholders have an equity."

The Commission did not question the efficiency of the Debtor. It referred at length to the testimony of Mr. Scandrett, one of the Trustees, on this point, and quoted his statement that,

> "the condition of the roadway, structures, and equipment was excellent, and as good as at the beginning of the depression in 1930." (R. 2179).

To that extent the road was as well off as in 1928-29. But the Commission did not know of the tremendous increase in efficiency that was already in the making. It knew of only part of the expenditure of $72,318,637 for additions and betterments made by the Trustees between the commencement of the reorganization proceedings and the end of 1941. (See Trustees' Reports to the District Court.)

The effect of these expenditures is now showing in operating results. The Debtor's ability to translate gross revenues into net earnings is already very different from that disclosed in the record before the Commission. This is illustrated by a comparison of 1940 and 1941 *(supra)* with 1928, 1929 and 1930 (R. 2176) and with the Group's estimate of a "future normal year," on which the Commission's plan was based (R. 2191).

Year	*Gross*	*Net*	*% Net of Gross*
1928	$170,554,000	$30,671,000	18.0
1929	171,361,000	29,105,000	17.0
1930	142,569,000	17,938,000	12.6
"Future Normal Year"	126,900,000	15,894,000	12.5
1940	114,375,000	14,867,000	13.0
1941	139,646,000	28,939,000	20.6

The plan approved by the Commission was based upon the assumption that 12½% of gross would be left for fixed charges. This was an important element in the "prospective earning power" upon which capitalization was based and stock wiped out. Recovery of the power to convert 17% or 18% of gross into net was considered too unlikely to support the existence of an equity. But in 1941 the ratio reached 20.6% and it is still rising. Instead of one-eighth,

as prophesied by the Commission, over one-fifth of gross is now flowing through to net. The Debtor is able to turn more gross revenues into net income now than in the heyday of 1928-9.

This is not due to the war.* The railroads have learned in the hard school of adversity. Throughout the depression, and even the prior period of unregulated competition, they have had to prepare to make their dollars go farther than they ever went before. Now that the depression is over they are reaping their reward.

That this would happen was recognized by competent authorities long before there was even a surmise of war. As far back as January 23, 1935, Mr. Eastman in his report as Coordinator of Transportation (74th Congress, 1st Session, House Document No. 89) recommending the revision of Section 77 under which we are now proceeding, said:

> "There are strong reasons to hope for much better railroad net earnings in the future. With revival of business, the net will probably improve at a faster rate than the gross. The drastic economies in recent years have been accomplished to a considerable extent at the expense of maintenance, and what has been deferred in this respect must be made good, but railroad managements have learned much through adversity and many of the economies will be permanent. The intensive studies which are now being made by the staff of the Coordinator and under the auspices of the Association of American

* In *Increased Railway Rates, etc.*, 1942, 248 I. C. C. 545, Commissioner Mahaffie, concurring, said (p. 614):

> "It should be remembered that increased traffic beyond a certain point does not necessarily result in increased net revenue. Furthermore, additional traffic in wartime may have to be handled in a way that greatly increases expenses. Consequently, any operating ratio practicable of attainment in peacetime may, with the same volume of traffic, be much greater under war conditions."

> Railroads will disclose many improvements which can be made in operation, equipment, service, and rates, and which will not only save expense but add materially to traffic" (p. 38).

The results of this development, however, were not, because they could not be, reflected in the record before the Commission. Hearings were closed early in 1938. The evidence stopped with the end of 1937, before any sign of a break in the depression or any chance for the tremendous physical improvements, then in progress, to make themselves felt.

Now that the change is apparent, it is clear, as it could not be in 1938, how far from correct were the gloomy forecasts which the Commission then made. Not only because the Debtor is doing more business than during the depression, but also because it has trained and equipped itself to make more out of the business which it does, are the Commission's conclusions as to capitalizable values and existence of an equity now shown to be wrong.

In addition to, and as a result of, the tremendous increases in gross revenues and net income the Debtor's cash on hand has increased from $13,400,000 at the effective date of the plan as approved by the Commission (Ex. 2 before the District Court, R. 1492), to over $35,400,000 at the end of 1941 (Reports of Trustees to the District Court), an increase of more than $22,000,000. This increase is a fact, now past, and its value does not depend on estimates or judgment. The increase alone is substantially double the amount of the entire claim of the Reconstruction Finance Corporation. It completely eliminates the necessity for setting aside bonds to raise $5,000,000 or $10,000,000 of cash for reorganization purposes as provided in the plan (R. 2227-8). $22,000,000 of cash is a substantial sum even for a

railroad of this size, and its importance in determining the value of total capitalizable assets and the proper treatment of creditors and stockholders cannot be ignored.

The District Court

The hearings in the District Court were held in September, 1940. The Debtor introduced in evidence the Trustees' annual reports for 1937, 1938 and 1939 (Exs. 1, 2, and 3; R. 1492), and a statement of operating revenues and income available for fixed charges through the first half of 1940* (Ex. 5; R. 1526-7).

So the District Court had facts more recent than the Commission. It knew that the gross earnings had gone from $99,436,000 in 1938 to $106,873,000 in 1939 and that they were increasing. It also knew that the income available for fixed charges had jumped from $4,962,000 in 1938 (the latest figure before the Commission) to $9,368,000 in 1939 and that it too was increasing, and increasing very much more rapidly than gross earnings.

The District Judge expressed doubt as to what his responsibility was under Section 77. Citing the opinion of this Court in *Warren* v. *Palmer*, 310 U. S. 132, he said:

> "That Court has not yet determined just what weight should be given by the Court to the findings and conclusions of the Commission" (R. 1870).

In this state of mind, he approved everything the Commission had done in spite of the evidence of increases in revenues and net income. There is not a reference to these increases anywhere in his decision. He discussed the testimony of the Debtor's expert, but gave no weight to his opinion (R. 1873-4). In approving the plan he gave no

* The significant figures have already been quoted.

indication that he had independently satisfied himself of its fairness, no statement of his reasons for his conclusions, and no weight whatsoever (so far as his words disclose) to anything that had happened after the close of the record before the Commission.

Even without the requirements of Section 77, this was error. Under the decisions in the line of cases beginning with *Knoxville* v. *Knoxville Water Co.*, 212 U. S. 1, cited earlier in this brief, a District Court commits error if it ignores radical changes which had been brought to its attention. In view of the "brigaded" responsibilities of court and Commission under Section 77 it was not merely error; it was failure to function as part of the "brigade."

The Circuit Court of Appeals

The error of the Circuit Court of Appeals, in addition to its failure to perceive that the Commission's error lay deeper than a mere lack of technical "findings," resulted from its ignoring of the entire change in the picture since the plan had been certified by the Commission.

It is true that the Court was not itself directly exercising the independent judgment required of the District Court. It was determining whether the District Judge, on the facts as well as the law, had properly exercised such judgment and had acted reasonably in saying that he was satisfied with the plan. But the Court of Appeals had even more recent events before it, not only in the form of general information by judicial notice, but the very figures by stipulation (R. 2275). Included in the record on appeal were the results of operations of the Debtor's property for all of 1940 and most of 1941. It knew that the gross revenues had increased from $99,436,000 in 1938 to $106,873,000 in 1939 and $114,375,000 in 1940, and it knew that the

first several months of 1941 showed an accelerating increase over 1940. It realized that the income available for fixed charges was no longer $4,962,000 or $9,368,000 as in 1938 and 1939, but $13,993,000 in 1940, and would be very much more than that in 1941.

It all but ignored these figures. After holding that the evidence supported the finding that the equity had no value (R. 2311), it said:

> "And this is true even though the evidence of current earnings made since the plan was approved, is received and considered" (R. 2311).

It is submitted that both the District Court and the Circuit Court of Appeals erred in not referring the plan back to the Commission with directions to review and reconsider in the light of subsequent developments its determination of the maximum capitalization and its finding that the stock had no value. Only so could they give the Commission a chance to bring the plan into line with current developments as required in the *Pottsville* case (309 U. S. 134). And only so could they fulfill the duty of courts sitting in equity and functioning cooperatively with the Commission under Section 77. The dissenting justices said that the *Atchison* case rested "upon its exceptional facts" (298 U. S. at 389). These exceptional times have made this an even more exceptional case.

A prompt reorganization is, of course, desirable. But a violent economic change in the course of reorganization may turn promptness into haste. A reorganization is truly prompt when the formulation of the plan follows as soon as practicable after the presentation of the evidence and when approval by the courts follows as soon as practicable after approval by the Interstate Commerce Commission.

The true purpose of expedition is to bring these events as near together as possible. The determination of values, especially if tested by earning power, should be brought as close to the future as it can be. It is folly to be prompt in 1942 as of 1938. The consummation of the plan cannot now with either wisdom or justice be brought back and made as of the time when the capitalization was determined. The capitalization, however, can, and should, be brought up as close as practicable to the time when the plan will be consummated.

Precisely this was what Congress had in mind when it added subsection (g) in the revision of 1935. Soundness was not to be sacrificed to speed. Time was to be taken for careful consideration. The hasty reorganization which had been considered to be required under the original 77 was to be avoided.

Senator Wheeler, when he presented subsection (g) to the Senate in 1935, said:

> "The present law contemplates hasty reorganizations. The courts have held that, unless there are prompt reorganizations under this statute, the cases must be dismissed, in which event they go back into the old-fashioned equity procedure, from the inefficiencies of which it was the purpose of section 77 to escape. The Federal judges are restive, and in a number of cases have issued orders indicating that unless the reorganizations are promptly accomplished, the cases will be thrown back into equity. This puts an unfortunate emphasis upon speed rather than soundness when the act is unworkable. * * *"
>
> "* * * Your committee feels that time ought to be taken to work out these reorganizations with careful consideration. The amended bill carries a provision in paragraph (g), page 28, line 24, which

> gives the judge discretion as to when he shall dismiss these cases" (Congressional Record, Vol. 79, p. 13764; Aug. 20, 1935).

In the report of the House Committee of the Judiciary, in which the bill was presented to the House, Mr. Sumners said much the same thing about subsection (g):

> "Your committee has considered the protection of stockholders and creditors against unnecessary sacrifice from reorganizations made in a period of depression when bad conditions are transient. In order to protect against hasty reorganizations, and in view of certain dicta in the decision of the Supreme Court in the Rock Island reorganization case above referred to indicating the necessity of prompt action under the present provisions of section 77, H. R. 8587 carries a new sub-paragraph (g), under which the judge is required to dismiss the proceedings if there is undue delay in a reasonably expeditious reorganization, the matter being left to his sound discretion, after considering the recommendation of the Commission" (Report No. 1283, 74th Congress, 1st Session, p. 3).

Thus the purpose of adding subsection (g)* was the protection of stockholders and creditors against haste, because haste, in a period of economic depression and low earnings, might result in the failure to recognize the true earning power of the property and the true worth of the rights of some of the creditors or stockholders and might thus cause "unnecessary sacrifice" by eliminating them forever from participation in the reorganized enterprise.

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* Subsection (g) reads,

> "If in the light of all the existing circumstances there is undue delay in a reasonably expeditious reorganization of the debtor, the judge, in his discretion, shall on motion of any party in interest or on his own motion, after hearing and after consideration of the recommendation of the Commission, dismiss the proceedings * * *"

In fixing total capitalization and eliminating the equity in the instant case, the Commission did this very thing and over-emphasized the desirability of speed. In its report, it said:

> "It is true that the plan will involve sacrifices on the part of the bondholders. But refusal by us to approve any plan until present uncertainties are resolved and the earning power of the system is stabilized would be to delay the reorganization indefinitely. No one of the parties has attempted to predict a time or describe the conditions when the making of a plan would be considered proper. This proceeding has been pending for more than four years, and, under any circumstances, cannot be concluded in the immediate future. Further postponement cannot remove the limitations upon allowable fixed charges imposed by the record of past earnings. Advantage should be taken of the progress so far made in the consideration of a plan for this debtor. In our judgment, an endeavor should be made now to devise a plan that will serve as a basis for the company's financial structure for the indefinite future" (p. 2220).

That was apparently written in the latter part of 1939.* It is ironical that the tide was even then turning and that within a very short time it was to become apparent that the "present uncertainties" had been "resolved" and the earning power had been "stabilized."

Prediction of a time and conditions "proper" for the making of a plan is no longer necessary. That time and those conditions are long since here. There is now no excuse for disregarding the intention of Congress as indicated in the adoption of subsection (g) by an "endeavor * * * to devise a plan" under circumstances which were not "considered proper."

* The "proceeding" which had "been pending for more than four years" was commenced on June 29, 1935. The Commission's Report was dated February 12, 1940.

The Commission clearly failed to comprehend the purpose and meaning of the statute in acting when and as it did. And the District Court and the Circuit Court of Appeals perpetuated that error in taking it for granted that some reorganization must be made, irrespective of the sacrifices it obviously entailed. Yet neither court had anything to say on the subject. Reorganization under this proposed plan would disregard the very thing which the Congress in enacting subsection (g) sought to accomplish, namely,

> "the protection of stockholders and creditors against unnecessary sacrifices from reorganizations made in a period of depression when bad conditions are transient."

This plan is based on evidence of "a period of depression," the "bad conditions" of which have already proved to be "transient."

There is still time to remedy this error by referring the proceedings back for a proper plan. The alternative is, not to approve a plan which is founded on demonstrably obsolete and misleading information, but under subsection (g), to dismiss the proceedings.

IV. The Plan must be disapproved because the Record was inadequate to permit either the Commission or the District Court to determine whether the treatment approved for the several classes of creditors and stockholders was fair and equitable and afforded due recognition to their respective rights.

In addition to the errors hereinbefore discussed, and quite aside from the significance of the tremendous changes in earnings, efficiency, condition of the property, and cash on hand which have occurred since the close of the hear-

ings, the Plan was fatally defective even at the time it was first approved because the record was inadequate to permit either the Commission or the court to determine whether it afforded due recognition to the rights of the several classes of creditors and stockholders. It even failed in several important instances to show what those rights were.

We will refer briefly to three defects in the record to illustrate the fundamental and far-reaching character of this inadequacy. There are other defects, some of which will doubtless be mentioned in the briefs of other respondents. Our failure to discuss them does not, however, indicate acquiesence in the statement of the Circuit Court of Appeals that "The plan, as such, ignoring the absence of findings, has support in the evidence" (R. 2312). There would seem to be no need here for an exhaustive enumeration of defects. Analysis of the record is a matter for the Commission on reference back. It is sufficient here merely to show that *no* plan could legally be approved on the basis of the record heretofore made.

Before any plan can be approved which changes the rights of any class of secured creditors with respect to security, priority or income, full information must be available as to the amount of the claim which is recoverable, the validity of the liens relied on and the value and earning power of the property against which such liens are asserted.

These are judicial questions which must be adjudicated by the court.* Their determination is necessary to the

* Claims must be filed and evidenced with, and allowed by, the Court (subsections (c) (7) (8); and see subsection (l)). While the determination of value and earning power is in the first instance entrusted to the Commission under subsection (e), the Court, as we have shown hereinabove, must be independently convinced of the correctness of the Commission's findings on these matters in order to be satisfied of the fairness of the plan.

allowance and valuation of claims against the Debtor's estate. Without such determination no plan can properly be found to comply with the requirements of the act.

In the present case, as is apparent from the claims advanced by the several classes of bondholders, many of these matters are in dispute and have not been adjudicated by the court or in the manner prescribed in the statute. There has been no judicial determination of the amounts of disputed claims, even in the case of some of the bonds. There has been no adjudication of the validity of conflicting liens asserted against important portions of the property. There has been no formula approved in the manner prescribed in the statute for allocating earnings and expenses to the divisions of the system which are subject to different liens or leases.

In the absence of authoritative information on these and similar matters, there is no basis for measuring the fairness of the treatment of one class against another, nor even for computing the total amount of claims which must be satisfied in the plan. And until such total is known there can be no finding as to value or lack of value for the equity of existing stockholders.

A. *There was no adequate segregation formula for allocating earnings and expenses among the several divisions of the Debtor's property which are subject to separate liens or leases.*

The Debtor's system includes four divisions subject to the liens of different mortgages and one (the Terre Haute) subject to a long-term lease. Each of these divisions is subject to two or more successive liens.

Section 77, subsection (c)(4), reads in part:

> "The judge *shall require* the officers of the Debtor or the Trustee or Trustees, at such time or times as the judge may direct, and in lieu of the schedules required by Section 7 of this Act, *to* file with the Court such schedules and *submit such other information as may be necessary to disclose* the conduct of the Debtor's affairs and *the fairness of any proposed plan;*" (italics added).

In the reorganization of a Debtor with different issues of bonds secured by different parts of its road, an adequate segregation formula for the allocation of earnings and expenses between the various divisions is necessary to disclose the fairness of any plan which changes the liens and priorities of the bonds. Congress realized this and made provision for such a formula in subsection (c)(10) which reads:

> "*The judge may direct the* debtor or the trustee or *trustees to keep such records and accounts,* in addition to the accounts prescribed by the Commission, *as will permit of such a segregation and allocation, as the necessities of the case may require, of the earnings and expenses between and to the divisions and parts of the railroad* or other property of the debtor *which are separately subject to the liens of the various mortgages* or deeds of trust, *or are separately subject to lease, and may refer to the Commission for its recommendations* after hearings thereon if the parties shall so request and/or the Commission determine necessary or desirable, *as to the method or formula by which such segregation and allocation shall be made;* and thereafter such segregation and allocation may be made at the expense of the debtor's estate." (Italics added.)

There is nothing in the record to indicate that the court had directed the trustees to keep such records and accounts as would permit of a segregation of earnings and expenses between the several divisions of the road, or had submitted any such data to the Commission for recommendation "as to the method of formula by which such segregation and allocation shall be made."

Perhaps the reason for these omissions was that the plan of reorganization originally submitted by the Debtor did not involve any reallocation of securities to the existing bondholders, but merely provided for a reduction in the amount of fixed interest. The hearings which were held before the Commission in 1935 and 1937 were directed to the Debtor's original plan. When the Group of Institutional Investors filed its plan in January, 1938, and hearings were rushed through thereon within a month, there was obviously not sufficient time to prepare the vital studies and expert analyses necessary to a proper segregation formula.*

The Group's plan proposed drastic changes in liens and priorities. It therefore necessarily required a proper segregation formula in order to determine whether it afforded due recognition to the rights of all classes of creditors. Nevertheless neither the Group nor any other party offered to furnish the sort of information necessary to the development of such a formula as the Act contemplates. On the contrary, the Debtor (R. 1021) and several other parties (R. 2207) sought postponement of the proceedings because of the complete inadequacy of the evidence on

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* For a description of the sort of study required for this purpose see the Commission's report in *N. Y., N. H. & H. R. R. Co. Reorganization*, 224 I. C. C. 723.

which to base the changes in liens and priorities proposed by the Group.*

Nevertheless the Commission, apparently believing that immediate reorganization was required by the statute even in the absence of such a formula, declined to permit further postponement or the presentation of further evidence. It approved the Group plan with only minor modifications as to the character of the securities, but with no change in the proposed readjustments of priorities and liens. And it did so in spite of the contentions of several of the par-

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* See statement of Robert T. Swaine, counsel for the Debtor at the close of the hearings (R. 1021-3), particularly the following:

"Secondly we ask for that adjournment in order to enable the classes of security holders, as to whom only small minorities are represented by the institutional investors committee, to study the propriety of taking away the lien of the Fifty-year Five's and giving it to the General Mortgage Bonds in exchange for a partial Pari Passu lien, second lien on the general mortgage line.

"That problem was never presented to the Debtor or to any security holders of this property until January 10th of this year.

"That involves so fundamental a question as to make it imperative, if there is to be any facts in the record upon which a plan of reorganization involving such a proposition can have any hope of being sustained by the Court, I say that is so fundamental a problem that there must be further evidence in the record than there is today.

"Now, it is not already in the record, but I would be glad to be sworn, if my statement to this effect cannot be admitted, but it is a fact that Mr. Sparrow, the man who is responsible for the only kind of a segregation study that was made, even he has stated to the board, and advised the Board of Directors himself, that in his opinion that study was inadequate to determine the propriety of the proposal for the disturbance of the lien.

"Now, I was prepared to call Mr. Colpitts last night, and offer his testimony. Mr. Colpitts is a man of experience, his firm has made many studies in reorganizations to determine the proper solution of exactly this kind of a problem.

"Had Mr. Colpitts been able to stay over until this morning, or had he been permitted to testify last night, he would have said that in his opinion there are no facts before the Board of Directors today upon which an expert in these problems can frame a conclusion as to whether it is proper to disturb the lien of the Fifty-year Five's as this plan proposes.

"Now, none of us is saying that we think it is improper. What we are saying is that we are agnostic, we don't know, and there is no record upon which the Bureau of Finance or the Interstate Commerce Commission or anybody else can found an opinion on that question" (R. 1022).

ties and elaborate expert testimony as to the inadequacy of the information contained in the record (R. 990-1020).

Such data as the Commission did have before it purporting to show the earnings of individual divisions of its system consisted of figures which had been compiled by states for tax purposes. It covered four scattered months of 1936, multiplied by three to represent a year's results (R. 1001). It therefore had never been intended to show earnings by divisions or for reorganization purposes, and it reflected only a part of a single depression year.

That the Commission did not affirmatively "recommend" it as setting forth a proper formula for segregation is apparent from its restrained comments:

> "We think that if the earnings studies for 1936 are to be rejected there is no satisfactory substitute short of a new segregation study embracing the entire system" (Commission's Report, R. 2254).

The District Court took the same attitude, saying:

> "* * * no better method was suggested and no sound reason was advanced in support of a different result" (R. 1889).

B. *There was no adjudication as to which class of creditors was entitled to prior lien rights in important portions of the Debtor's property.*

The Debtor's two chief mortgages, the General Mortgage with a first lien on most of the lines east of the Missouri River, and the Fifty Year Mortgage with a lien (subject only to the lien of the small First and Refunding Mortgage) on the lines west, both claim a first lien on seventeen pieces of lines east of the river, referred to as "the Pieces of Lines East."

The state of the record in regard to these pieces and its inadequacy as a basis for approving a plan under the requirements of Section 77 are indicated in the Commission's comment:

> "The propriety of crediting the First and Refunding Mortgage or the Fifty Year Mortgage with the earnings of the 'pieces of lines east' is rendered doubtful in the absence of a judicial determination of the question whether these lines are subject to the first lien of the First and Refunding Mortgage or to that of the General Mortgage." (R. 2252; see also R. 2170-1).

These "Pieces of Lines East" are described in the Record at 221-2 and 230 by their termini. Five of them are described as "bridge" lines "the strategic value of which cannot be ignored" (R. 1010-11). Three of them are "essential parts of through lines carrying diversified traffic between major gateways" (R. 335). The income derived from them appears to be substantial. For 1931 it was stated to be $885,000 (Ex. 92; R. 343 and 583). From July 1, 1935 to December 31, 1938, it was put at something over $691,000 (R. 1783).

No plan could possibly be found to afford due recognition to the rights of bondholders under these two mortgages in advance of an authoritative determination as to which mortgage was entitled to the earnings of these 575 miles of track. Yet the Commission approved a plan which fundamentally altered the rights of both mortgages without waiting for such a determination. All that the District Court had to say on the subject was

> "that the status of certain separate lines referred to in the Record as Seventeen Pieces of Lines East is in dispute as to whether or not the lien of the General Mortgage or of the Debtor's First and Refunding Mortgage is prior" (1864).

The Court made no adjudication on this "dispute," either in determining the validity and amount of claims filed against the Debtor's estate or in any other manner or proceeding. It made no finding or ruling on the subject in its order approving the Plan (see R. 1978-1992), although it was requested to do so (R. 1424) and under subsection (c)(4) was under a definite mandate to do so.

C. *There was no adjudication as to the amount of claims of holders of Adjustment Mortgage Bonds.*

Under the Adjustment Mortgage of February 2, 1925, there are outstanding $182,873,693 of 5% bonds due in the year 2000. These bonds carry interest at the rate of 5% payable only to the extent that "available net income" as defined in Article 5 of the mortgage indenture* is sufficient for such payment. Unpaid interest was not cumulative prior to 1930. Thereafter it is cumulative in that interest at 5% from that date to the date of payment is payable whenever available net income is sufficient therefor, and in any event is payable when the principal of the bonds becomes payable at maturity or on declaration of default.

The legal effect of the indenture provisions concerning the payment of interest is a matter of considerable uncertainty. The mortgage trustee has filed a claim to participate in the reorganization of the Debtor's estate on the basis of the principal of the bonds and any interest to which the bondholders have a contractual right (R. 1803). It is plain from the Record that there could have been no "available net income" for the payment of interest at any time prior to the termination of the hearings before the Commission or the effective date of the Plan as heretofore ap-

* The indenture of the Adjustment Mortgage appears in the Record before the Commission as Exhibit 28 (R. 280). Its provisions are summarized in the opinion of the Commission authorizing its issuance (131 I. C. C. 673, at pp. 683-4).

proved. Did the bondholders have a contractual right to any unpaid interest? That question was not answered by any adjudication of the court as to the amount of the claim of these bondholders.

The Circuit Court of Appeals, referring to the decision of this Court in *Consolidated Rock Products Company* v. *Du Bois*, 312 U. S. 510, said: "(b) Interest accrued on bonds (not contingent interest which has not been earned) is entitled to the same priority as the principal" (R. 2308).

The interest on the Adjustment Mortgage bonds is clearly "contingent." Whether the particular provisions of that indenture gave the bondholders a contractual right to have anything added to their principal on account of the possibility of future payments under the cumulative interest provisions is a difficult question of law which must be adjudicated before the amount of the participation of those bondholders in the reorganization can be determined.

The amount involved in this undetermined question is so large as to have a fundamental effect on the reorganization of the Debtor. The Commission in computing the total amount of the Debtor's obligations as of December 31, 1938 included $79,550,055 of unpaid interest on the Adjustment Mortgage bonds (Appendix to the Commission's Report, R. 2269). This constitutes two-thirds of the entire amount of unpaid interest included in the figure for total debt at the effective date of the plan, and is almost 8% of such total debt. If this contingent interest were excluded the total debt, as determined by the Commission, would be reduced from $626,000,000 to $547,000,000.

Until this legal question is determined, we submit that neither the Commission nor the Court can be satisfied that the Plan is fair to, and affords due recognition to the

rights of, the holders of Adjustment Mortgage bonds and interests junior to them.

* * * * *

An additional error in the findings of both Commission and Court arises from their failure to observe that under the indenture of the Adjustment Mortgage (Ex. 28, pp. 10, 15, 20 and 89, and see 131 I. C. C. 673, 683) interest is not payable on unpaid interest. The Record contains a computation of the interest which would be required on the total debt as of December 31, 1938. The Commission said:

> "Computations were made by counsel for the Committee and introduced at the oral argument showing the interest charges on the total debt at more than $29,000,000 a year" (R. 2259).

The District Judge also relied on these computations (R. 1874).

They were made by applying 4.7%, which was stated to be the average rate of interest paid by the Debtor on its funded debt (R. 1639, 1663), to the total debt at the effective date of the Plan, namely, $626,926,331 (R. 2174, 2269). 4.7% of this figure is $29,465,537.

As we have said, this figure for total debt includes $79,550,055 of unpaid interest on the Adjustment Mortgage bonds. As interest was not payable on that interest, the result was over-stated by the amount of 4.7% of $79,550,055, or $3,738,852. Deducting this from the figure of "more than $29,000,000" reduces it to $25,726,685, representing the amount necessary to pay interest at the average rate of 4.7% on the total debt as of December 31, 1938, after excluding interest on the Adjustment Mortgage bonds.

* * * * *

Thus there is a serious and unadjudicated question whether nearly $80,000,000 of claims have a legal right to participate in the reorganization. And, regardless of the answer to that question, there is an error in the Commission's and the Court's findings as to the amount necessary to pay interest at the old average rate on the total debt. This uncertainty and this error both affect the validity of the findings of the Commission that there is no value for the equity of the stock.

If the courts shall ultimately hold that the interest on the Adjustment Mortgage bonds is not legally recoverable, then the total debt would be less than the total new capitalization heretofore authorized by the Commission even if that capitalization were not increased. Such a situation would certainly require reconsideration of the finding that stockholders are not entitled to participate, even on the basis of the record before the Commission and without changing any of the Commission's other conclusions.

Reduction from "more than $29,000,000" to $25,700,000 a year in the amounts necessary to pay interest at the old average rate on existing indebtedness would materially affect any conclusion which might have been based on earnings at the level of 1928-29, or on the earnings actually achieved in 1941. What we have said above to the effect that earning power cannot be less than current earnings means that even if we were to take the 1941 results as measuring earning power, the Debtor's earning power is sufficient to show over $3,000,000 for its existing stock.

Conclusion

The District Court erred when it approved the Commission's conclusion that the maximum capitalization should be reduced and that the equity of the stock had no

value, without (1) requiring the Commission to give its reasons for those conclusions, (2) reviewing them in the light of the subsequent events and changed conditions known to the Court, (3) adjudicating the amounts of claims of creditors, particularly the claim of holders of the Debtor's Adjustment Mortgage bonds to unearned interest.

The District Court further erred when it approved an allocation of securities to various classes of creditors based on inadequate and unreliable evidence, without (1) requiring the preparation of information necessary to disclose the fairness of the Plan, including a formula for the segregation of earnings and expenses, and (2) adjudicating the lien rights of the several mortgages to substantial portions of the Debtor's property.

The Circuit Court of Appeals rightly held that the Plan lacked support in findings and that the District Court could not properly approve it.

The Circuit Court of Appeals erred, however,

(1) in its expressions of approval of the Commission's Plan, knowing (a) that the record before the Commission was insufficient to determine many of the issues involved in such a plan as would comply with the statutory requirements, (b) that the Commission had given no reasons for its conclusions, (c) that the District Court could not properly have satisfied itself in the absence of such reasons, and (d) that the District Court had not considered the Plan in the light of subsequent events and changed conditions;

(2) in not itself reviewing the conclusions and the order of the District Judge in the light of the accumulated subsequent events of which it had judicial or record knowledge;

(3) in directing that the Plan be referred back to the Commission merely to make findings on certain issues of fact without instructing the Commission to reopen its hearings and reconsider the Plan in the light of the circumstances then existing and on the basis of a record adequate to determine all the issues involved in framing a plan which would fully comply with the requirements of Section 77.

We ask this Court to require modification of the decision and order of the Circuit Court of Appeals as herein indicated and to affirm them as so modified.

Respectfully submitted,

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